



DEPARTMENT OF
FINANCE

GRAY DAVIS, GOVERNOR

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October 18, 2002

Ms. Jane I. Henderson, Ph.D., Executive Director
California Children and Families Commission
501 J Street, Suite 530
Sacramento, CA 95814

Dear Dr. Henderson:

Final Audit Report on the Children and Families Trust Fund and Related Funds

Enclosed is the final report on our financial audit of the Children and Families Trust Fund and related funds, for the fiscal year ended June 30, 2002. Our audit was performed under interagency agreement number CCFC-6851, between the California Children and Families Commission and the California Department of Finance.

The enclosed report is for your information and use. The responses to the Findings and Recommendations as well as our evaluation are included herein. We believe the recommendations included in this report will help the Commission, the Board of Equalization, and General Services, Contracted Fiscal Services, to correct identified issues.

If you have any questions regarding this report, please contact James Kong, Manager, or Cheryl L. Lyon, Supervisor, at (916) 322-2985.

Sincerely,

Samuel E. Hull, Chief
Office of State Audits and Evaluations

Enclosure

cc: Mr. Joseph Munso, Chief Deputy Director, Children and Families Commission
Mr. Bryan Hobson, Chief, Administrative Division, Children and Families Commission

A F_{INANCIAL} S_{TATEMENT} A_{UDIT}

California Children and Families Commission Children and Families Trust Fund and Related Funds

Prepared By:
Office of State Audits and Evaluations
Department of Finance

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The Department of Finance, Office of State Audits and Evaluations, performed this audit under Health and Safety Code Section 130150. The purpose was to audit the Balance Sheets and Statements of Revenues, Expenditures, and Changes in Fund Balance of the Children and Families Trust Fund and related funds (Funds) for the 12 months ended June 30, 2002. The financial audit objectives were to:

- Express an opinion on the financial statements based on our audit, conducted in accordance with standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.
- Verify that the financial statements were prepared in conformity with the accounting practices as prescribed by the State of California, which is a comprehensive basis of accounting other than generally accepted accounting principles.
- As necessary, report on internal control weaknesses, as well as noncompliance with applicable laws and regulations, and provide recommendations for improving the controls over the Funds' operations.

This report is intended solely for the information and use of the California Children and Families Commission and the Legislature, and is not intended to be and should not be used by anyone other than the specified parties. However, this report is a matter of public record and its distribution is not limited. Requests for copies should be made to the California Children and Families Commission.

STAFF:

James Kong, CPA
Manager

Cheryl L. Lyon, CPA
Supervisor

Cecilia Michaels
Alma Bermudez



INDEPENDENT AUDITOR'S REPORT

Ms. Jane I. Henderson, Ph.D., Executive Director
California Children and Families Commission
501 J Street, Suite 530
Sacramento, CA 95814

We have audited the accompanying Balance Sheets and Statements of Revenues, Expenditures, and Changes in Fund Balance of the Children and Families Trust Fund and related funds (Funds), for the fiscal year ended June 30, 2002. These financial statements are the responsibility of the California Children and Families Commission's (Commission) management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note 2, these financial statements were prepared in conformity with the accounting practices as prescribed by the State of California, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the Balance Sheets and Statements of Revenues, Expenditures, and Changes in Fund Balance present fairly, in all material respects, the results of the Commission's operations for the fiscal year ended June 30, 2002, in conformity with the basis of accounting described in Note 2 to the financial statements.

In accordance with *Government Auditing Standards*, we have also issued our report dated September 26, 2002, on our consideration of the Commission's internal control over the Children and Families Trust Fund and related Funds, and on our tests of its compliance with applicable laws and regulations. That report is an integral part of an audit performed in accordance with *Government Auditing Standards*, and should be read in conjunction with this report in considering the results of our audit.

This report is intended solely for the information and use of the Commission and the Legislature, and is not intended to be and should not be used by anyone other than the specified parties. However, this report is a matter of public record and its distribution is not limited.

A handwritten signature in black ink, reading "Samuel E. Hull". The signature is fluid and cursive, with the first letters of the first and last names being capitalized and prominent.

Samuel E. Hull, CPA
Chief, Office of State Audits and Evaluations
(916) 322-2985

September 26, 2002

BALANCE SHEETS

California Children and Families Commission Balance Sheets For the Year Ended June 30, 2002

	Children and Families Trust Fund (0623)	Counties Children and Families Account (0585)	Mass Media Communications Account (0631)	Education Account (0634)	Child Care Account (0636)	Research and Development Account (0637)	Administration Account (0638)	Unallocated Account (0639)
Assets:								
Cash	\$ 996	\$ 177	\$ 611	\$ 269	\$ 543	\$ 888	\$ 375	\$ 459
Investments	6,570,000	47,192,000	72,488,000	88,415,000	48,065,000	64,809,000	13,411,000	34,413,000
Receivables	93,066,091	0	0	0	0	0	0	0
Due from Other Funds	450,494	80,423,216	6,993,420	6,205,415	3,663,028	3,876,990	1,223,877	3,640,028
Expense Advances	0	0	0	0	0	0	554	0
Prepayments	0	0	0	0	0	0	226,000	0
Due from Other Governments	0	0	0	0	0	0	0	0
Due From Other Appropriations within the Same Fund	0	0	0	0	0	0	0	75,000
Total Assets	\$100,087,581	\$127,615,393	\$79,482,031	\$94,620,684	\$51,728,571	\$68,686,878	\$14,861,806	\$38,291,973
Liabilities:								
Payables	\$ 0	\$ 40,921,541	\$67,040,721	\$69,075,337	\$45,230,221	\$46,985,514	\$ 268,859	\$30,788,515
Due to Other Funds	100,087,581	0	204,357	408,715	286,100	299,724	37,031	0
Due to Other Appropriations within the Same Fund	0	0	0	0	0	0	0	0
Total Liabilities	100,087,581	40,921,541	67,245,078	69,484,052	45,516,321	47,285,238	305,890	30,952,001
Fund Balance:	0	86,693,852	12,236,953	25,136,632	6,212,250	21,401,640	14,555,916	7,339,972
Total Liabilities and Fund Balance	\$100,087,581	\$127,615,393	\$79,482,031	\$94,620,684	\$51,728,571	\$68,686,878	\$14,861,806	\$38,291,973

The accompanying notes are an integral part of the financial statements.

STATEMENTS OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCE

California Children and Families Commission Statements of Revenues, Expenditures, and Changes in Fund Balance For the Year Ended June 30, 2002

	Children and Families Trust Fund (0623)	Counties Children and Families Account (0585)	Mass Media Communications Account (0631)	Education Account (0634)	Child Care Account (0636)	Research and Development Account (0637)	Administration Account (0638)	Unallocated Account (0639)
Revenues:								
Cigarette Tax	\$625,225,285	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
Interest on Investments	1,331,322	1,671,953	2,429,073	2,610,884	1,665,926	1,973,970	400,911	1,035,184
Escheated Checks	201	0	0	0	0	0	1,200	0
Other Financing Sources - Operating Transfers In	0	479,558,714	35,966,904	30,222,420	17,983,452	17,983,452	5,994,484	11,988,968
Total Revenues and Other Sources	626,556,808	481,230,667	38,395,977	32,833,304	19,649,378	19,957,422	6,396,595	13,024,152
Expenditures:								
Operating Expenditures	958,416	493,424,384	78,347,347	73,964,928	60,603,289	47,454,567	3,450,121	33,516,550
Other Uses - Operating Transfers Out	625,598,392	0	0	0	0	0	0	0
Total Expenditures and Other Uses	626,556,808	493,424,384	78,347,347	73,964,928	60,603,289	47,454,567	3,450,121	33,516,550
Excess of Revenues and Other Sources Over (Under) Expenditures and Other Uses	0	(12,193,717)	(39,951,370)	(41,131,624)	(40,953,911)	(27,497,145)	2,946,474	(20,492,398)
Fund Balance, July 1, 2001	0	98,887,569	52,188,323	66,268,256	47,166,161	48,898,785	11,609,442	27,832,370
Fund Balance, June 30, 2002	\$ 0	\$ 86,693,852	\$ 12,236,953	\$ 25,136,632	\$ 6,212,250	\$ 21,401,640	\$ 14,555,916	\$ 7,339,972

The accompanying notes are an integral part of the financial statements.

NOTES TO FINANCIAL STATEMENTS

**California Children's and Family Commission
Children's and Family Trust Fund and Related Funds
Notes to Financial Statements
For the Fiscal Year Ended June 30, 2002**

NOTE 1 Definition of Reporting Entity

The Children and Families Trust Fund (Fund 0623) and its related accounts were created by the *California Children and Families Act of 1998* (Act). The Act is intended to promote, support, and improve the early development of children from the prenatal stage to five years of age. The programs authorized by this Act are administered by the California Children and Families Commission (Commission) and by county Children and Families Commissions.

Effective January 1, 1999, Section 30131.2 of the Revenue and Taxation Code authorized the State Board of Equalization (Board) to collect 87 cents for each cigarette pack distributed and a surtax on other tobacco products. Of the 87 cents collected, 50 cents is allocated to the Fund. All Board adjustments, including Act related administrative costs are deducted from the cigarette and tobacco products taxes, before the rest of the revenues are transferred to the Fund 0623.

The Fund 0623 was established to provide funding for research and development, education, training and other functions specified in the Act. However, it primarily functions as a pass-through clearing account, with all funds that are transferred in being disbursed to its related accounts according to allocation percentages established by the Act. The county commissions receive 80 percent of the funding and the Commission receives 20 percent, which is allocated to six separate accounts, as illustrated in the following table.

Fund/Account	Tax Revenue Allocation	Fund Purpose
Counties Children and Families Account (0585)	80%	This fund is established for the 80 percent of the funds received in the California Children and Families Trust Fund (0623) to be allocated and appropriated to county commissions and expended for the purposes authorized in accordance with each county's strategic plan.
Mass Media Communications Account (0631)	6%	To provide funding for communications to the general public utilizing television, radio, newspapers and other mass media furthering the goals and purposes specified in the <i>California Children and Families Act of 1998</i> .
Education Account (0634)	5%	To provide funding for education goals and purposes as specified in the <i>California Children and Families Act of 1998</i> .
Child Care Account (0636)	3%	To provide funding for child care goals and purposes as specified in the <i>California Children and Families Act of 1998</i> .
Research and Development Account (0637)	3%	To provide funding for research and development goals and purposes as specified in the <i>California Children and Families Act of 1998</i> .
Administration Account (0638)	1%	To provide funding for administrative costs and other purposes as specified in the <i>California Children and Families Act of 1998</i> .
Unallocated Account (0639)	2%	To provide funding for any other purposes of the <i>California Children and Families Act of 1998</i> , except that no expenditures for administrative costs may be made from this account.

Each county commission receives a portion of the monies equal to the percentage of the number of live births recorded in the relevant county (for the most recent reporting period) in proportion to the entire number of live births recorded in California (for the same period). Vital statistics compiled by the Department of Health Services are used. All fund expenditures must be incurred in accordance with the provisions of the Health and Safety Code, Section 130105 (d), subsections (A) through (F).

NOTE 2 Summary of Significant Accounting Policies

a. Basis of Presentation

The Children and Families Trust Fund and related fund accounts (Funds) are classified as *Other Governmental Cost Funds* for State of California financial reporting purposes. *Other Governmental Cost Funds* are one of four classes of the State of California's special revenue funds and are used to account for other revenues that are restricted by law for specified purposes.

b. Measurement Focus and Basis of Accounting

The accounting method used for the Funds' financial accounting and reporting purposes is in compliance with the accounting policies and procedures prescribed by the California State Administrative Manual and the California Government Code, which is a comprehensive basis of accounting

other than generally accepted accounting principles (GAAP). Except for encumbrances being accrued as accounts payable and expenditures at year-end, rather than a reserve to fund balance, this method is consistent with the modified accrual basis of accounting, whereby revenues are recorded when they become measurable and available and expenditures are recorded when the related liability is incurred.

c. Revenue

Revenues consist of the cigarette taxes collected on sales of cigarette packs and other tobacco products, and interest income earned on funds deposited in the Surplus Money Investment Fund (SMIF.) Additionally, unclaimed checks are escheated to the issuing fund.

d. Expenditures

Expenditures are recognized when claims to the State Controller are filed against fund appropriations, or when monies are transferred to the State Payroll Revolving Fund for the payment of salaries and wages. Valid expense commitments, including encumbrances, are accrued as accounts payable at June 30.

e. Cash and Pooled Investments

Cash is deposited in the State's centralized treasury system, which combines the balances of state agencies into a single bank account to simplify cash management. Idle Fund cash is invested in the State's Surplus Money Investment Fund (a pooled investment account), managed by the Pooled Money Investment Board. Each fund whose monies are deposited in this pooled investment account has an equity share in the balance, with investment income allocated to participants based on relative equity at month end. The Fund's "Cash and Pooled Investments" are available upon demand and are considered cash equivalents for financial statement presentation.

f. Due To/From Other Funds

The "Due to Other Funds" account for Fund 0623 represents the cigarette tax revenues due to the other seven Commission funds as described in Note 1. Additionally, the "Due to Other Funds" account for the other six funds represents allocations due to the Unallocated Fund 0639 for the School Readiness Program administered by the Commission. Under this Program, the Commission distributes funds to eligible counties, in addition to the required 20 percent allocation of cigarette taxes as noted in Note 1, to assist with the development of children ages zero through five to ready them for school.

The "Due from Other Funds" account represents the amounts due from the Children and Families Trust Fund (Fund 0623) for the cigarette tax revenue allocations and SMIF interest.

g. Encumbrances

In accordance with State accounting procedures, valid encumbrances are recognized as expenditures at fiscal year end. However, this accounting treatment is not consistent with GAAP, which requires that encumbrances be classified as a reserve of fund balance. The Funds recognized a total \$239,619,204 of encumbrances as accounts payable and expenditures at fiscal year end. Encumbrances are fund commitments related to unperformed contracts, purchase orders, and other agreements. Encumbrances are estimated as to amounts and are recorded when purchase orders, contracts, or other similar documents of a purchase agreement are issued. However, because encumbrances are estimated commitments, the related expenditure incurred may vary and/or may never be recognized. The following table identifies the amount of encumbrances accrued as accounts payable and recognized as expenditures as of June 30, 2002.

SUMMARY OF ACCRUED ENCUMBRANCES	
Fund	ENCUMBERED AMOUNT
Children and Families Trust (0623)	\$ 0
Counties Children and Families (0585)	0
Mass Media Communications (0631)	49,303,445
Education (0634)	69,047,939
Child Care (0636)	45,105,050
Research and Development (0637)	46,974,061
Administration (0638)	225,263
Unallocated (0639)	28,963,446
Total	\$239,619,204

h. Fund Balance

Fund balance is the difference between Fund assets and liabilities, and represents the unencumbered balance of all appropriations for which the period of availability extends beyond June 30, 2002.

i. Interfund Transfers

Legally authorized transfers between State funds are reported on the Statements of Revenues, Expenditures, and Changes in Fund Balance as "Other Financing Sources – Operating Transfers In" and "Other Uses – Operating Transfers Out," and are accounted for as increases or reductions of the Fund Balance.

"Operating Transfers Out" of the Children and Families Trust Fund 0623 equals the sum of the statutorily required backfill of the Proposition 99 health-related education and research programs and the Breast Cancer Fund, and the "Operating Transfers In" of the six related Funds. The "Operating Transfers In" are calculated based on the applicable percentage of Fund 0623 revenues, which include cigarette taxes and interest income.

The backfill is required by the Health and Safety Code Section 130105 which states, "The State Board of Equalization shall determine within one year of the passage of this act the effect that additional taxes imposed on cigarettes and tobacco products by this act has on the consumption of cigarettes and tobacco products in this state. To the extent that a decrease in consumption is determined by the State Board of Equalization to be the direct result of additional taxes imposed by this act, the State Board of Equalization shall determine the fiscal effect the decrease in consumption has on the funding of any Proposition 99 (the Tobacco Tax and Health Protection Act of 1988) State health-related education or research programs in effect as of November 1, 1998, and the Breast Cancer Fund programs that are funded by excise taxes on cigarettes and tobacco products. Funds shall be transferred from the California Children and Families Trust Fund to those affected programs as necessary to offset the revenue decrease directly resulting from the imposition of additional taxes by this act. Such reimbursements shall occur, and at such times, as determined necessary to further the intent of this subdivision."

Historically, backfill is calculated every October. Approval by the Board of Equalization's Directors must be obtained prior to the transfer of funds. Backfill amounts transferred for fiscal years 1999-00 and 2000-01 totaled \$24 million per year.

j. Retirement Plan

Employees of the Commission are members of the California Public Employees' Retirement System (CalPERS), which is a defined benefit, contributory retirement plan. Retirement contributions by employees are set by statute as a percentage of payroll (Tier I employees), or are zero (Tier II employees). Retirement contributions are actuarially determined under a program where total contributions plus CalPERS' investment earnings will provide the necessary funds to pay retirement benefits when incurred. The Department's employer contributions are included in the cost of personal services. For further information, please refer to the annual single audit of the State of California, and to the CalPERS Comprehensive Annual Financial Report.

k. Vacation and Sick Leave

Under the State's accounting guidelines, the costs of vacation and sick leave are not recorded at the time the benefits are earned, but rather when incurred. When leave is used, the personal services expenses account is charged. Under GAAP, the accumulation of employees' vacation and sick leave credits is accounted as a liability to be charged when the credits are used.

NOTE 3 Budgeting and Budgetary Control

The Funds are classified as *Other Governmental Cost Fund* for budgetary purposes. An *Other Governmental Cost Fund* is used to account for revenues from taxes, licenses, and fees where the use of such revenues is restricted by law for particular functions or activities of government. Program funds are continuously appropriated without regard to fiscal year.

Commission management is responsible for exercising budgetary control to ensure that appropriations are not overspent at the fund level. The State Controller's Office is responsible for statewide appropriation control and does not allow expenditures in excess of authorized appropriations.

NOTE 4 Pending Litigation

The Commission is involved in two refund actions that challenge the constitutionality of the Children and Families Act of 1998 (Act). The actions are:

- California Association of Retail Tobacconists (CART), et al. v. Board of Equalization, et al.
- Cigarettes Cheaper!, et al. v. Board of Equalization, et al.

CART and Cigarettes Cheaper! allege that the Act violates 11 sections of the California Constitution and related provisions of the law. CART and Cigarettes Cheaper! are seeking refunds of over \$5 million and \$4 million, respectively. The two cases were successfully defended and are now pending at the Court of Appeal. Should the State lose on appeal, the Commission may be required to forfeit the collection of \$750 million, plus interest, received annually since 1999. This could amount to several billion dollars by the time the cases are resolved.

NOTE 5 Subsequent Event

During audit fieldwork, misstatements to the amounts recorded as encumbrances were identified. Specifically, the misstatements affected Funds 0631, 0636, 0637, 0638, and 0639 totaling \$(2,555); \$1,104,746; \$(39,451); \$(84,688); and \$881,353, respectively. These misstatements were material to Funds 0636 and 0639 fund balances. The Commission posted an adjusting entry to correct the financial statements on October 3, 2002. Therefore, amounts presented in the Balance Sheet and Statement of Revenues, Expenditures, and Changes in Fund Balance represent the adjusted balances for the five Funds.

REPORT ON COMPLIANCE AND INTERNAL CONTROL OVER FINANCIAL REPORTING

Ms. Jane I. Henderson, Ph.D., Executive Director
California Children and Families Commission
501 J Street, Suite 530
Sacramento, CA 95814

We have audited the Balance Sheets and Statements of Revenues, Expenditures, and Changes in Fund Balance of the Children and Families Trust Fund and related Funds (Funds), for the fiscal year ended June 30, 2002, and have issued our report thereon dated October 15, 2002. We performed this audit under an interagency agreement with the California Children and Families Commission (Commission). We conducted our audit in accordance with the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the Commission's Balance Sheets and Statements of Revenues, Expenditures, and Changes in Fund Balance are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed one instance of noncompliance that is required to be reported under *Government Auditing Standards*. See Finding 5 of the Findings and Recommendations Section.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Commission's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the Balance Sheets and Statements of Revenues, Expenditures, and Changes in Fund Balance, and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control and its operation that we consider to be reportable conditions under *Government Auditing Standards*. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal controls that, in our judgment, could adversely affect the Commission's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. See Findings 1 through 4, and 6 through 8 in the Findings and Recommendations section for further discussion.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of internal control would not necessarily disclose all matters in internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. We consider Findings 1 and 2 to be material weaknesses.

This report is intended solely for the information and use of the Commission and the Legislature, and is not intended to be and should not be used by anyone other than the specified parties. However, this report is a matter of public record and its distribution is not limited.

A handwritten signature in cursive script, reading "Samuel E. Hull".

Samuel E. Hull, CPA
Chief, Office of State Audits and Evaluations
(916) 322-2985

September 26, 2002

FINDINGS AND RECOMMENDATIONS

During our audit of the California Children and Families Commissions' (Commission) Children and Families Trust Fund and related funds (Funds), we noted certain matters concerning the accounting and administrative controls that we consider reportable conditions. Furthermore, we consider Findings 1 and 2 to be material weaknesses. If left uncorrected, these weaknesses could compromise the accuracy of the Commission's financial statements.

FINDING 1 Monitoring of Fiscal Activities at the Commission Needs Improvement

Condition: The Commission does not adequately review and monitor its fiscal information for completeness and accuracy. Although General Services', Contracted Fiscal Services (CFS) maintains the Commission's official accounting records, the Commission also maintains its own accounting records for fiscal and program monitoring purposes. However, the Commission does not ensure that the accounting information it is maintaining reconciles to the accounting records maintained by CFS. For example, there is no identification, review, or reconciliation of the:

- (1) recorded/budgeted fund balances per Commission records with the California State Accounting and Reporting System (CALSTARS) records;
- (2) Commission's record of encumbrance balances with CALSTARS records (we identified mispostings totaling \$1,859,405); (3) encumbrance balances with open purchase orders; (4) outstanding purchase orders and invoices with amounts paid; and (5) Commission's property listing with CALSTARS records.

The Commission has a fiduciary responsibility for ensuring the accuracy of its records. The quality of system-generated information affects management's ability to control activities, make appropriate decisions, and prepare reliable financial reports. Without ongoing monitoring and reconciliation, the potential for undetected errors or irregularities occurring and not being detected increases.

This is a recurring condition from a prior audit.

Criteria: SAM Section 20050 states, " . . . Internal accounting controls comprise the methods and procedures directly associated with safeguarding assets and assuring the reliability of accounting data. Internal administrative controls comprise the methods and procedures that address operational efficiency and adherence to management policies . . . the elements of a satisfactory system of internal accounting and administrative controls, shall include, but are not limited to:

- A system of authorization and record keeping procedures adequate to provide effective accounting control over assets, liabilities, revenues, and expenditures
- An effective system of internal review.”

- Recommendations:
- A. Establish a process for monitoring Fund balances. Reconcile Commission’s record of Fund balances monthly and budgeted Fund balances annually with amounts per the CALSTARS records.
 - B. Establish a procedure for monitoring outstanding purchase orders and invoices submitted for payment. Reconcile outstanding purchase orders and invoices with amounts paid.
 - C. Establish a procedure to monitor and reconcile the Commission’s property listing with the CALSTARS records.

FINDING 2 Monitoring of Fiscal Activities at CFS Needs Improvement

Condition: The CFS does not adequately review or monitor multi-year contract balances or the related year-end encumbrance accruals. Specifically, the CFS tracks contracts individually; however, payments made and encumbrance accruals are not reconciled with the individual contracts at year-end. We judgmentally selected recorded encumbrances totaling \$10,000 or greater for testing. Of the items selected for testing, we reviewed the related contract files for completeness and validity. We found seven encumbrance mispostings within five contracts totaling \$1,859,405. The mispostings were due to unrecorded encumbrances, invalid encumbrances, and transposition errors. While the Commission has a fiduciary responsibility to ensure the accuracy of its financial information, the CFS also has a fiduciary responsibility to ensure the accuracy of information recorded and reported to the State Controller’s Office. Without adequate review and monitoring, the encumbrances reported in the financial statements are at an increased risk of being materially misstated.

Criteria: *SAM Section 20050* states, “. . . Internal accounting controls comprise the methods and procedures directly associated with safeguarding assets and assuring the reliability of accounting data. Internal administrative controls comprise the methods and procedures that address operational efficiency and adherence to management policies the elements of a satisfactory system of internal accounting and administrative controls, shall include, but are not limited to:

- A system of authorization and record keeping procedures adequate to provide effective accounting control over assets, liabilities, revenues, and expenditures
- An effective system of internal review.”

SAM Section 10608 states, "All encumbrances unliquidated as of June 30 will be reviewed to determine whether they are valid obligations of the year just ended . . . and whether the amounts encumbered are the most accurate that can be determined."

Recommendation: Establish a process for reviewing contracts to ensure all encumbrances are recorded, accurate, and valid. Ensure encumbrance accruals are reviewed for validity and accuracy prior to reporting the amounts in the year-end financial statements.

FINDING 3 Uncorrected Prior Audit Findings

Condition: We reviewed the status of 13 observations identified during three prior audits we conducted of the Commission. Of the 13 observations, five were reportable conditions identified in our Internal Control Review dated May 2001, and the other eight were discussion issues noted among the three audits. We are pleased that the Commission has resolved six of the outstanding observations. However, seven continue to remain unresolved and therefore, require further attention from the Commission. Repeat observations deemed reportable conditions during our current audit are identified as such in this report.

Criteria: *The Financial Integrity and State Manager's Accountability Act (FISMA) of 1983 (Government Code Section 13400 et. Seq.)* places responsibility for establishing and maintaining an agency's system of internal accounting and administrative control with the agency head.

State Administrative Manual (SAM) Section 20050 states that a symptom of control deficiencies is identified when detected internal control weaknesses are not acted upon in a timely fashion.

Recommendation: Develop and implement corrective actions on unresolved prior audit observations and findings identified in this report as recurring conditions. The corrective action plans should include specific actions to be taken and timetables for accomplishing them.

FINDING 4 Monitoring of Property at the Commission Needs Improvement

Condition: The Commission does not maintain adequate accountability over its property. Specifically, the Commission could not account for two laptop computers, two computer monitors, or a copy machine. For some items, the serial numbers were either missing or differed from those listed on the property ledger. Additionally, equipment was not consistently or accurately tagged with state identification numbers. The Commission was able to reconcile the copier and one monitor with the property listing. Although the Commission is not required to complete a physical inventory until October 2002, procedures to ensure the accuracy of the information reported and the proper monitoring and maintenance of property are necessary to safeguard assets.

This is a recurring condition from a prior audit.

Criteria: *SAM Section 20050* states, “. . . Internal accounting controls comprise the methods and procedures directly associated with safeguarding assets and assuring the reliability of accounting data. Internal administrative controls comprise the methods and procedures that address operational efficiency and adherence to management policies the elements of a satisfactory system of internal accounting and administrative controls, shall include, but are not limited to:

- A system of authorization and record keeping procedures adequate to provide effective accounting control over assets, liabilities, revenues, and expenditures
- An effective system of internal review.”

SAM Section 8650 and 8651 states that all state property, regardless of whether capitalized or expended, will be controlled, identified, and tagged.

Recommendation: Ensure that capitalized property (acquisition cost equal to or greater than \$5,000) or property deemed sensitive, are appropriately identified and accounted for in the property ledger.

FINDING 5 Reduced to a discussion item and removed from this report.

FINDING 6 Supervisory Review at the CFS and BOE Needs Improvement

Condition: We observed the following instances where supervisory review procedures at the CFS and BOE could be improved.

- CFS supervisors do not consistently review or approve accounting records maintained on behalf of the Commission. Specifically, the same CFS staff person is responsible for the recordkeeping of the Commission’s funds. CFS supervisors do not consistently review and/or approve this work. We observed that staff initiate and post adjustments to Commission accounting records without supervisor knowledge. Furthermore, monthly reconciliations of CFS accounting records with the State Controller’s records are not reviewed for completeness or accuracy. We observed that only 2 of 12 months, or 17 percent included evidence of supervisory review. Failure to appropriately review staff work increases the risk of errors, irregularities, and material misstatements to account balances occurring and remaining undetected.
- BOE supervisors do not consistently review or approve adjustments made to the Children and Families Trust Fund revenues. We reviewed three months of transactions, and found no evidence of supervisory review documented. While our testing did not identify any errors or irregularities with the adjustments posted, the lack of consistent review increases the risk of errors

and irregularities occurring and remaining undetected; thus affecting the amount of revenues received by the Fund.

Criteria:

SAM Section 20050 states, “. . . Internal accounting controls comprise the methods and procedures directly associated with safeguarding assets and assuring the reliability of accounting data. Internal administrative controls comprise the methods and procedures that address operational efficiency and adherence to management policies the elements of a satisfactory system of internal accounting and administrative controls, shall include, but are not limited to:

- A system of authorization and record keeping procedures adequate to provide effective accounting control over assets, liabilities, revenues, and expenditures
- An effective system of internal review.”

SAM Section 7901 states, “The accuracy of an agency's accounting records may be proved partially by making certain reconciliations and verifications. Reconciliations must be completed between the agency accounts and the accounts maintained by the [State Controller's Office] to disclose errors as they occur All reconciliations will be prepared monthly within 30 days of the preceding month, with the exception of property reconciliations.”

SAM Section 7924 states, “At least quarterly, or monthly, depending upon the volume of property transactions, agencies will reconcile the acquisitions and dispositions of capitalized property with the amounts recorded into the property ledger.”

SAM Section 7908 states, “All reconciliations will show the preparer's name, reviewer's name, date prepared, and date reviewed.”

Recommendation:

CFS and BOE should implement procedures to ensure that staff work is consistently reviewed and approved by an appropriate level of management. Evidence of management review and approval should be documented.

FINDING 7

Lack of Separation of Duties at the Commission

Condition:

We observed a lack of separation of duties and a key person dependency over the monitoring of financial information at the Commission. Specifically, the same staff person is responsible for maintaining and reviewing the accuracy of all supporting subsidiary schedules and documentation for the Funds, reconciling subsidiary information to the accounting records maintained by CFS, monitoring county contracts, initiating and tracking county payments, and inventorying copies of paid claim schedules received from CFS. A lack of separation of duties and a key person dependency increases the risk of errors or irregularities occurring and remaining undetected.

Criteria: *SAM Section 8080* requires department heads to maintain adequate levels of separation of duties within their departments.

SAM Section 20050 states, “. . . the elements of satisfactory system of internal accounting and administrative controls, shall include, but are not limited to A plan of organization that provides segregation of duties appropriate for proper safeguarding of state assets.”

Recommendation: Review and segregate incompatible duties.

FINDING 8 Recordkeeping of School Readiness Program Funds at the Commission Needs Improvement

Condition: The Commission does not adequately account for and monitor funds disbursed for the School Readiness Program (Program). Under this Program, the Commission will distribute \$200 million over four years to eligible counties. The funds are being disbursed in equal annual allotments beginning with the 2001-02 fiscal year. The Commission is authorized to distribute the first two annual implementation fund allotments during 2001-02, if counties request both allotments. Subsequent allotments are to be issued every July, until the total award is disbursed. We observed inaccuracies within the Commission’s subsidiary expenditure schedule detailing individual payments to the counties. We identified a \$506,963 unexplainable variance between the subsidiary schedule and CALSTARS. From this schedule, we judgmentally selected five counties for testing. We identified payments exceeding the authorized 2001-02 fund allotments (up to two allotments) for four counties (80 percent) totaling \$325,000. The excess payments were determined to be pre-payments of the 2002-03 allotments (third allotment.) This practice is inconsistent with Commission policy, leads to an inequity of fund disbursements, results in a loss of State interest earnings, and inaccurately presents the Commission’s subsidiary Program expenditure schedule for the 2001-02 fiscal year. Additionally, sufficient supporting documentation was not maintained in the county files, thus inhibiting our verification of payment disbursements.

Criteria: *SAM Section 20050* states, “. . . Internal accounting controls comprise the methods and procedures directly associated with safeguarding assets and assuring the reliability of accounting data. Internal administrative controls comprise the methods and procedures that address operational efficiency and adherence to management policies the elements of a satisfactory system of internal accounting and administrative controls, shall include, but are not limited to:

- A system of authorization and record keeping procedures adequate to provide effective accounting control over assets, liabilities, revenues, and expenditures
- An effective system of internal review.”

Guidelines and tools for completing a school readiness program application, March 2002, Section 2.e states, “county commissions will receive allocations for four years beginning on the date their application is approved . . . and thereafter, every July.”

Updated School Readiness Frequently Asked Questions, Item 16, states “...County Commissions may request up to two years of their four-year Implementation Funds immediately.”

Recommendation: Ensure subsidiary records are adequately maintained and all Program funds are appropriately monitored. Ensure sufficient supporting documentation is maintained for all programs administered by the Commission.

Ensure allotments are issued in compliance with the Commission's Program guidelines.

RESPONSES TO THE FINDINGS AND RECOMMENDATIONS


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Memorandum

Date: October 10, 2002

TO: Samuel E. Hull, Chief
Office of State Audits and Evaluations
Department of Finance
915 L Street
Sacramento, CA 95814

FROM: Jane Henderson 
Executive Director
California Children & Families Commission
501 J Street, Suite 530
Sacramento, CA 95814

SUBJECT: DRAFT AUDIT REPORT FOR CCFC ANNUAL FISCAL AUDIT

The California Children and Families Commission (CCFC) staff has carefully reviewed the results of the audit performed by the Office of State Audits and Evaluations for Fiscal Year 2001/2002. We are pleased to note that the primary purpose of the audit disclosed that the revenues entrusted to this commission have been correctly and responsibly managed according to California State accounting rules and regulations.

I would like to address the internal control aspect of the audit that produced several findings directed at the procedures currently employed by CCFC staff. Findings 2, 5 and 6 pertain to other departments and response to them is not the responsibility of CCFC. The remainder, which we believe are not material findings, but discussion items only, are responded to below.

1. Finding 1 – CCFC staff do continuously monitor fund balances. It is essential to ensure sufficient funds to support the commission's programs. Internal records, CALSTARS, and SCO reports are all used in this process. Staff reviews purchase orders and contracts and advises Contracted Fiscal Services, Department of General Services (DGS) to close or disencumber them as appropriate. However, as a result of this review, future adjustments will be scheduled to occur immediately prior to the annual audit to eliminate this issue. In addition, CCFC and DGS have begun to hold monthly meetings to coordinate to continuously improve monitoring and reconciliation procedures.

Property records have been effectively reconciled with DGS records, and annual physical inventories have been conducted, more frequently than required by SAM, in order to ensure property control. The inconsistencies identified by the extensive audit of our property control system were caused, not by those procedures, but because of a lack of centralized property reception. This has already been corrected and new procedures are being incorporated into the Administrative Manual. This issue is duplicated in Finding #4 and #3, Finding 4.

2. Finding 2 – To be responded to by DGS.

3 Finding 3 – We found that, although six of the prior internal control observations had been corrected, the audit listed eight as conditions that still exist. We do not entirely concur with the comments and recommendations contained in this report.

Finding #1 – We are unsure of the purpose or intent of this Finding. Administrative costs are monitored and reported monthly. Internally costs are not based on revenues; costs are based on expenditures authorized and approved by management. This is essential in an environment of continuous appropriation and declining revenues. If this finding is directed to the Board of Equalization (BOE), we suggest it be removed as an “existing finding” on our report.

Finding #3 – All orders to Office Depot, or now Boise Cascade are authorized by a manager/supervisor, and are available for the auditor’s review. Cal Card purchases have also required prior authorization. These procedures are stated in the commission’s Administrative Manual. We are notifying staff, however, that verbal authorization for emergency Cal Card purchases will no longer be permitted.

Finding #4 – Clearly CCFC is performing all of the tasks listed in this finding. They are discussed in Finding #2 of the audit. The response to that finding is sufficient to address this issue. Additionally, property control systems are in place and two physical inventories have been conducted by CCFC in the past two years.

Finding #5 – CCFC performs year-end accruals according to the instructions received from DGS. CCFC will meet with DGS to determine if that process needs to be changed.

Finding #6 – Accounts are reconciled to CALSTARS reports every month. CCFC processes encumbrances via contracts and PO’s. Encumbrances are recorded and approved by DGS. In discussion with DGS, CCFC is following the correct

procedures for encumbering these documents. The process of identifying encumbrances has been the source of discussion and is handled by DGS according to State accounting policies. As with #5, if that is to be changed, it must be coordinated with the State Controller's Office (SCO), DGS, DOF and CCFC. Continuing to list these subjects of ongoing debate as a finding is not productive or useful.

Finding #7 – Both documents have been completed, however, the Disaster/Operational Recovery Plan is still in draft form, waiting for final approval. Both documents will be submitted simultaneously when approved.

Finding #8 – Automatic password change will be implemented for all CCFC staff within 30 days.

Finding #9 – Efforts to provide back-up staff has been stymied by the statewide hiring freeze. Additional positions will back up key employees as soon as the freeze is lifted. It should be recognized that the statutes sets a limit on the amount of revenue available for the Administration of CCFC programs. This limitation is also a factor in key person dependency. This is a duplication of Finding 7.

4 Finding 4 – CCFC has a property list of over 460 items, most of which are correctly accounted for, capitalized, tagged and reconciled with the CALSTARS listing. This topic is also addressed, incorrectly, in #3, Finding 4. Discrepancies were the result of a variety of problems including a decentralized receiving process. These issues have all been addressed and corrected.

5. Finding 5 – To be addressed by BOE.

6. Finding 6 – To be addressed by DGS.

7 Finding 7 – Separation and segregation cannot occur unless an additional position is filled, after CCFC receives an exemption from the hiring freeze or it is lifted. (#3, Finding #9 above)

8 Finding 8 – All transactions, including encumbrances, adjustments, and implementation and program disbursements are captured in detail in an Access database, which is available for auditing at any time. The auditors did not avail themselves of the database or original documents, i.e., encumbrance documents. No request for documentation was left unfilled. Back-up for all transactions was available in CCFC files. All transactions are scrupulously reconciled to CALSTARS and against

Claim Schedules. We are clearly aware of the size and scope of this project and have made extraordinary efforts to ensure that a detailed audit trail including full authorization and justification is provided for every disbursement. We are mystified at the assertion that there is \$325,000 in outstanding duplicate payments. The designation as 'duplicate' appears to illustrate the auditors' lack of understanding of the compliance requirements of the program and the authorization for payment schedule. The suggested requirement to adjust the program schedule to fit the auditor's concept of appropriate disbursement is inappropriate and will not be accommodated. There are no outstanding duplicate payments for FY01/02 to refund.

The California Children and Families Commission began operation on January 1, 1999, and since its inception, the staff and management of CCFC have made a concentrated effort to develop and support the highest quality of business operations. We have been scrupulous in observing all State laws, policies, procedures and directives, and the results have begun to approach our goals, however, constant improvement is our continuous objective. During this challenging period we have received outstanding assistance from the Department of Finance, particularly the Fiscal Systems and Consulting Unit and the Office of State Audits and Evaluations. We believe that as a very new organization, we have achieved an excellent fiscal management process, and we are proud of our accomplishments. CCFC has always welcomed the annual audits as excellent opportunities to learn better methods of monitoring our administrative operations.



STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

ADMINISTRATION DEPARTMENT

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JAMES E. SPEED
Executive Director

October 15, 2002

Mr. Samuel E. Hull, Chief
Department of Finance
Office of State Audits and Evaluations
300 Capitol Mall, Suite 801
Sacramento, California 95814

Dear Mr. Hull:

Thank you for the opportunity to review your draft finding regarding the Board of Equalization's (BOE's) processing of revenues deposited into the Children and Families Trust Fund. We concur with your finding and will implement procedures in accordance with your recommendation as indicated in the following response:

FINDING 6 – Supervisory Review at the BOE Needs Improvement

BOE supervisors do not consistently review or approve adjustments made to the Children and Families Trust Fund revenues. We reviewed three months of transactions, and found no evidence of supervisory review documented. While our testing did not identify any errors or irregularities with the adjustments posted, the lack of consistent review increases the risk of errors and irregularities occurring and remaining undetected; thus affecting the amount of revenues received by the Fund.

Recommendation

The BOE should implement procedures to ensure that staff work is consistently reviewed and approved by an appropriate level of management. Evidence of management review and approval should be documented.

BOE Response

Although the adjustments referred to in this finding accounted for less than one half of one percent of the total revenues collected for this fund during the fiscal year being audited, the amount of such adjustments may change in the future. Accordingly, the BOE has developed procedures whereby supervisory review of all subsequent adjustments will occur.

Sincerely,

Dade Powers
Acting Deputy Director

Cc: Mr. James E. Speed
Mr. Timothy Boyer
Ms. Vicky Kjer

Ms. Darlene J. Allen
Mr. Timothy Bryan
Ms. Cindy Hanneman



MEMORANDUM

Date: October 10, 2002

To: Mr. Samuel E. Hull
Department of Finance
Office of State Audits and Evaluations
Sacramento, California 95814

From: Department of General Services
Contracted Fiscal Services

Subject: DRAFT FINDINGS ON CHILDREN AND FAMILIES COMMISSION

Thank you for the opportunity to respond to your office's draft audit report on the Children and Families Commission (CFF). The Department of General Services, Contracted Fiscal Services (CFS) as accountants for the CFF had two findings in the audit that requires a response.

Finding: Inadequate Monitoring of Fiscal Activities at Contracted Fiscal Services (Finding 2)

The report stated CFS does not monitor multi-year contracts and as a result, our year-end encumbrances are understated by \$1.8 million. We agree that we did have some discrepancies last year with the reporting of encumbrances resulting in our accruals being understated. The largest discrepancy occurred in the Child Care Account (fund 0636) where accruals were under reported by 1.8%. CFS will review its process for handling multi-year contracts and revise its procedures, where necessary, to ensure the accuracy of our accounting records.

Finding: Inadequate Supervisory Review at the CFS (Finding 6)

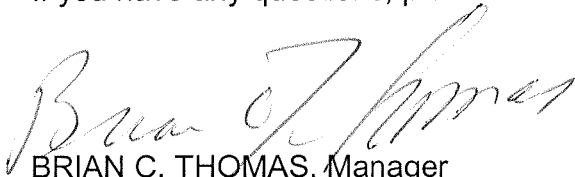
The audit report states the CFS supervisors do not consistently review or approve accounting records. We do not agree with this statement. CFS has procedures in place where supervisors review the accounting records maintained by their staff. We review all accounting records for the period ending December 31st, March 31st, and at June 30th. We also have a "double review" at year-end. This is where two different supervisors review the same accounting records in order to ensure accurate year-end statements. Other reviews are made on an as needed basis. CFS has procedures and performs reconciliations of the Commission's accounting records to the State Controller's Office within 20 days after the end of each month. If the accountant has a reconciliation problem, then the supervisor will assist with and review the reconciliation. CFS has assigned a well-trained professional level accountant to perform professional accounting duties for the Commission. In this particular case, the employee has shown her professional knowledge by having passed all parts of the CPA examination. We see no reason why we should have to review her work on a more frequent basis.

The audit report also stated that failure to appropriately review staff work increases the risk of errors, irregularities, and material misstatements to account balances occurring and

remaining undetected. The audit report did not report any findings that could have been prevented had our supervisors reviewed the Commission's reconciliation on a more frequent basis. In addition, prior audits of the Commission by the Department of Finance and independent audits of our Bond Funds by private CPA firms did not raise this issue nor identify any audit finding that occurred because of our reconciliation review procedures.

CFS believes that we have a cost-effective system of authorizations and record keeping procedures adequate to provide effective accounting control over assets, liabilities, revenue and expenditures. We believe that a more frequent review would not significantly improve our internal controls, but would add to the cost of our services that we must pass on to our clients.

If you have any questions, please contact me on (916) 376-5237.

A handwritten signature in cursive script, appearing to read "Brian C. Thomas".

BRIAN C. THOMAS, Manager
Contracted Fiscal Services
Department of General Services

Cc: Children and Families Commission

EVALUATION OF RESPONSES

We are in receipt of, and have included in the final report, the Children and Families Commission (Commission), Board of Equalization (BOE), and Department of General Services, Contracted Fiscal Services (CFS) responses to our draft report. We have evaluated the responses and for findings where adequate corrective action has been proposed, we have not provided additional comments. However, we provide the following comments for findings where there was disagreement, adequate corrective action not proposed, or where additional explanation was deemed necessary.

Finding 1 Monitoring of Fiscal Activities at the Commission Needs Improvement

The Commission disagrees with portions of this finding.

The Commission states that it continuously monitors fund balances, purchase orders and contracts encumbrances, and that property records have been effectively reconciled with CFS' records. The Commission states that it uses CALSTARS, State Controllers Office reports, and internal records during this process. While we agree that the Commission has policies and procedures for record review, these policies and procedures are not sufficient to ensure that the subsidiary schedules maintained by the Commission or amounts posted by CFS are accurate and complete. During audit fieldwork, we observed that fund balance monitoring was not documented, reconciliations of the Commission's internal records with CALSTARS and/or State Controller's Office records were not documented, and the property listing maintained by the Commission did not reconcile with CALSTARS.

Although the CFS maintains the Commission's official accounting records, the Commission also maintains its own records for fiscal and program monitoring purposes. These records are the underlying documentation supporting the amounts recorded by CFS and reported in the financial statements, and therefore, should be accurate and complete. This is accomplished through a formalized process of monitoring and reconciliation of records to ensure that amounts reported reflect the actual financial activity of the Commission. Reconciling items should be documented and tracked as to their disposition. As a result, we maintain our finding and recommendations.

Finding 3 Uncorrected Prior Audit Findings

The Commission disagrees with portions of this finding.

The Commission has a fiduciary responsibility to monitor and implement corrective action, where warranted, on audit findings and discussion items noted during audits. Our draft audit report identified eight unresolved observations. The Commission provided individual responses to the eight unresolved items. We provide the following comments for specific observations as follows:

- Observation 1: This observation concerns costs charged by BOE related to the BOE's administration of the cigarette tax. The amount of administrative costs charged by the BOE directly affects the amount of revenues received by the Commission, and therefore, the Commission has a responsibility to monitor, and if warranted, to obtain the BOE's justification for the costs. However, we agree that the observation is a BOE issue and should not be considered an outstanding issue for the Commission to resolve. Accordingly, we revised Finding 3 to exclude this observation and it now states that 13 observations were identified with six observations resolved and seven unresolved.
- Observation 3: During audit fieldwork, we requested to review the Commission's file containing the supporting authorizations for all Cal-Card purchases. The Commission was unable to locate this file for our review. Although we were able to review copies of invoices for purchases charged to the Cal-Card, we were unable to verify that purchases were appropriately pre-authorized by Commission management. Because the Commission did not provide the supporting file for our review, we were unable to verify the Commission's assertion, and therefore, this observation remains unresolved.
- Observation 4: See Finding 4 for our comments concerning this observation.
- Observation 6: The Commission is responsible for authorizing encumbrance accruals and forwarding that information to CFS for posting into the CALSTARS accounting records. Furthermore, the Commission is responsible for ensuring amounts posted by CFS accurately represent the financial activity of the Commission. This is accomplished through ongoing monitoring and account reconciliations. Proper reconciliation of records includes, but is not limited to, a formalized process of reconciling CALSTARS account balances to the Commission subsidiary schedules and documenting and researching reconciling items. The Commission could not provide documentation supporting its reconciliations with CFS' records. Therefore, this observation remains unresolved.

Finding 4 Monitoring of Property at the Commission Needs Improvement

The Commission disagrees with this finding. The following comments concern the Commission's responses to Findings 1, 3 (Observation 4), and 4.

The Commission states that property control systems are in place and that two physical inventories have been conducted by the Commission in the past two years. Additionally, the Commission also states that property records have been effectively reconciled with CFS records, and that the inconsistencies noted during our audit were due in part to a decentralized property reception and not the property policies and procedures of the Commission.

Although a decentralized system of property reception may have contributed to the property control weaknesses identified during our audit, we believe the Commission's property policies and procedures could be improved to increase its effectiveness in safeguarding assets. During audit fieldwork, the Commission could not account for five of 37 items (13 percent) selected for testing. The Commission was able to reconcile only two of the items prior to the completion of our fieldwork. Additionally, during our audit, the Commission conducted a physical review of its

computers and monitors. The Commission identified 13 monitors and two laptop computers that were not tagged with a state identification number. Although the Commission subsequently tagged these items, effective monitoring of property could have identified these missing tags prior to a physical count. Furthermore, the Commission states that it has conducted two physical inventories in the past two years. We requested to review the documentation supporting the Commission's two physical inventory counts. This information was not provided and the Commission informed us that copies of the counts were not retained. Thus we were not able to verify that a physical inventory had been conducted nor whether any variances had been researched and necessary corrections posted.

The Commission has a responsibility to maintain adequate property accountability by performing ongoing monitoring activities and periodic inventories. Property monitoring should include tagging the item upon receipt and logging the item along with its serial number, state identification tag number, location, and cost in the Commission's property listing. Physical inventories should include reconciling the information obtained during the physical inventory, such as state identification tags and serial numbers, to the Commission's property listing and CFS records. Discrepancies such as duplicate tag numbers, missing serial numbers, and/or missing items should be noted, researched, and resolved. Documentation detailing the physical inventory counts and reconciliations should be maintained and retained for audit, as detailed in the State Administrative Manual Section 8652. We therefore, maintain our finding and recommendation.

Finding 5

Finding 5 is reduced to a discussion item and removed from this report.

Finding 6 Supervisory Review at the CFS and BOE Needs Improvement

The BOE concurs with this finding while the CFS disagrees with this finding. We provide the following comments to the CFS' response.

The CFS states that it has procedures in place where supervisors review the accounting records maintained by their staff. The CFS also states that it has competent staff performing the recordkeeping for the Commission. While we do not dispute the fact that the CFS has supervisor review policies and procedures established; we observed instances where the procedures were not being implemented as intended. Furthermore, while staff may be competent, errors do occur. For example, the CFS states that it reviews all accounting records for the periods ending December 31, March 31, and June 30, plus a fiscal year-end review. We reviewed the monthly reconciliations of CFS accounting records with the State Controller's records for the fiscal year 2001-02 and observed only 2 of 12 months (17 percent) and the year-end reconciliation included evidence of supervisory review. The State Administrative Manual requires monthly reconciliations detailing the preparer's and reviewer's names and dates. Additionally, the CFS states that our audit report did not identify any findings that could have been prevented had CFS supervisors reviewed the Commission's reconciliations more frequently. Our audit report, as noted in Finding 2, identified mispostings of encumbrances totaling \$1,859,405. Had the CFS consistently reviewed and monitored Commission activities, we believe these mispostings could have been identified and corrected prior to the issuance of the Commission's year-end financial statements. We therefore, maintain our finding and recommendation.

Finding 7 Lack of Separation of Duties at the Commission

The Commission concurs with this finding.

The Commission states that proper segregation and separation of duties cannot occur unless an additional position is filled. Although a sufficient number of staff is essential in achieving appropriate levels of separation of duties, alternate procedures could be implemented to reduce the Commission's risk in the absence of additional staff. For example, the Commission could review existing staff's responsibilities and duties and allocate input, reconciliation, and review duties among those available. The Commission could also implement a secondary level of review for reconciliations.

Finding 8 Recordkeeping of School Readiness Program funds at the Commission Needs Improvement

The Commission disagrees with this finding.

The Commission states that it maintains an Access database detailing the payments made to the counties for the School Readiness Program (Program). The Commission also states that we did not avail ourselves of the database or original documents and that back-up for all transactions was available in Commission files. Additionally, the Commission states that all transactions are scrupulously reconciled to CALSTARS and against claim schedules.

During audit fieldwork, we requested and received the Commission's database listing that details the payments made to counties for the Program. This listing did not reconcile with the payments reported in the CALSTARS records for fiscal year 2001-02. Reconciling items were not provided by the Commission, nor were we able to reconcile the \$506,963 variance. During our initial attempt at reconciliation, we identified pre-payments of \$325,000 for four counties. The counties requested and the Commission disbursed the first three annual allotments during 2001-02, which is inconsistent with Program guidelines. The Program guidelines state that the counties can request and receive up to two annual allotments during the first year, however the remaining allotments are to be disbursed thereafter, every July. The \$325,000 represents the Commission's pre-payment of the counties third year allotment, which should have been disbursed after July 1, 2002.

Additionally, we selected five counties for testing and reviewed the corresponding files maintained by the Commission. These files did not contain all the supporting documentation such as the county requests for Program implementation fund payments and Commission disbursement memo's authorizing payments to the counties. Furthermore, the subsidiary schedule maintained by the Commission should support the amounts reported per the CFS records and identify reconciling items. This would provide staff with an accurate description of the fiscal year payments that were issued to the counties as well as provide an appropriate audit trail to verify account balances.

The Commission has a responsibility to maintain adequate documentation and a sufficient audit trail that supports the amounts reported in the financial statements.

Adequate documentation includes a detailed listing of payments made to counties per fiscal year, reconciling this listing with CALSTARS, identifying reconciling items, and maintaining sufficient supporting documentation within the individual county files. As a result of our additional analysis of documentation provided by the Commission, we have clarified Finding 8 to state that pre-payments rather than duplicate payments were issued to the four counties. Further, we added additional Program guidelines to the criteria to clarify our finding.